VZCZCXRO3873
RR RUEHDU RUEHJO RUEHMR
DE RUEHSA #2395/01 1601456
ZNR UUUUU ZZH
R 091456Z JUN 06
FM AMEMBASSY PRETORIA
TO RUEHC/SECSTATE WASHDC 3935
INFO RUCNSAD/SOUTHERN AFRICAN DEVELOPMENT COMMUNITY
RUCPDC/DEPT OF COMMERCE WASHDC
RUEATRS/DEPT OF TREASURY WASHDC

UNCLAS SECTION 01 OF 02 PRETORIA 002395

SIPDIS

SENSITIVE

SIPDIS

USDOC FOR 4510/ITA/MAC/AME/OA/JDIEMOND
TREASURY FOR OAISA/JRALYEA/BCUSHMAN

E.O. 12958: N/A
TAGS: EFIN ECON EINV SF
SUBJECT: Central Bank Unexpectedly Raises Interest Rates

Sensitive but Unclassified; Protect Accordingly. Not For Internet Distribution.

¶1. (U) Summary. Reserve Bank Governor Tito Mboweni announced June 8 an increase of 50 basis points to 7.5 percent in the central bank's repurchase (repo) rate. In its statement, the Reserve Bank's Monetary Policy Committee (MPC) cited deterioration in the inflation outlook, continued growth in credit extension, a widening current account deficit, and uncertainties in international financial and commodity markets as the basis for the move. While local economists were divided on whether the MPC should raise the repo rate, most did not expect an increase. Initial reaction from local economists, however, was largely negative, with some warning that the increase would lead to slower growth. A spokesman for COSATU, the largest trade union confederation, said the Reserve Bank decision "contributed to continued joblessness and poverty." The increase, announced shortly before the stock market closed, led to a 6.5 percent drop in the JSE All Share Index. Commercial banks subsequently raised prime lending rates an equivalent amount to 11 percent. End Summary.

¶2. (U) The MPC statement said that inflation risks were now on the up side. While its previous forecast had showed an inflation peak at just below 5 percent in the first quarter of 2007, the latest forecast expected inflation to breach the upper end of the South Africa Reserve Bank's (SARB) 3-6 percent target range and peak at 6.2 percent that same quarter. The committee noted that the Bureau of Economic Research's (BER) most recent survey showed a slight deterioration in inflationary expectations in 2007 and 2008. BER (Stellenbosch University) now expected inflation to average 4.9 percent in both of the coming two years, compared to 4.6 percent and 4.8 percent in its previous survey.

¶3. (U) The statement repeated earlier concerns about the continued growth in credit extension. It said that household real consumption expenditure increased 6.9 percent (annualized) in the first quarter of 2006. Bank loans to the private sector grew 24 percent and 23 percent (y/y) in March and April respectively, while the ratio of household debt to GDP rose to 68 percent in the first quarter, from 65 percent the previous quarter.

¶4. (U) As another concern, the SARB said the current account deficit continued to widen in the first quarter due in part to weak export growth and higher volumes and values of crude oil imports. Capital flows, however, had remained strong, more than financing the deficit and enabling a further increase in the SARB's foreign exchange reserves.

¶5. (U) The SARB also stated that the international environment posed increased risks for inflation. It noted that the rand had depreciated against all major currencies at a time when the U.S. dollar had also been weakening. It cited the decline in commodity prices and a re-rating of emerging market risk as contributing to the depreciation. Finally, the SARB noted that the price of Brent crude had averaged around $75 per barrel since the last MPC meeting, leading to sharp increases in retail fuel prices over the last three months.

¶6. (U) Although the MPC noted that favorable inflation factors included continued fiscal discipline, a moderate trend in unit labor costs, and benign world inflation, its statement concluded that a moderate adjustment in the repo rate was warranted.

¶7. (U) The rate hike was the first increase since September 2002 when the repo rate rose from 12.5 percent to 13.5 percent. Since then the rate had fallen to a 25-year low. Following the announcement, the JSE All Share Index fell 6.5 percent to 18,414, the largest one-day decline in April 17, 2000. Sector indexes experienced similar declines. Forex markets, however, were stable with the rand trading

in the R6.7 to R6.8 per U.S. dollar range.

¶8. (U) Initial reaction from local economists was largely negative, with many questioning the revised inflation projections and warning that the increase would lead to slower growth, undermining the government's new Accelerated and Shared Growth Initiative. Business Day, the leading national daily, said the decision to increase rates was "strictly" a "no-brainer" based on the SARB's inflation targets, but it questioned the decision when markets generally still expect inflation to remain within the target range and its effect on the economy. Trade unions had called for a rate decrease (an unrealistic position) because of the adverse effects the strong rand has had on manufacturers and exporters.

¶9. (SBU) Comment. While the increase was largely unexpected, and was more than expected by those advocating an increase, it was not unprecedented. The SARB moved aggressively to raise the repo rate in 2002 when inflation jumped sharply. Recently Mboweni has been publicly critical of the continuing increase in private sector debt levels and has warned that the next move in interest rates would be up. While high petroleum prices have not yet pushed up inflation, contrary to the expectations of local economists, the SARB is now worried that they will soon. This, combined with the continued growth in domestic debt levels and uneasiness in international markets, prompted the SARB to move preemptively.
TEITELBAUM